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IN THE

Supreme Court of the United States

October Term, 1980

No. 80-1484

U.S. STEEL CREDIT CORPORATION,

Petitioner,

v.

AMERICAN FLETCHER MORTGAGE COMPANY, INC., AMERICAN FLETCHER NATIONAL BANK AND TRUST COMPANY and AMERICAN FLETCHER CORPORATION,

Respondents.

On Petition For A Writ Of Certiorari To The United States Court of Appeals For The Seventh Circuit

BRIEF OF RESPONDENTS IN OPPOSITION

Theodore R. Boehm
(Counsel of Record)
James H. Ham, III
Baker & Daniels
810 Fletcher Trust Building
Indianapolis, Indiana 46204
(317) 636-4535
Attorneys for the Respondents

Central Publishing Company, Inc., Indianapolis, IN 46206

QUESTION PRESENTED

Did petitioner's participation in mortgage loans made to a developer for the construction of a condominium project involve a "security" within the meaning of the federal securities laws under the tests set forth by this Court applied to the facts of this case?

AFFILIATE OF RESPONDENTS

The only affiliate of the Respondents, other than wholly-owned subsidiaries, is American Fletcher Suisse, a Swiss corporation. American Fletcher Mortgage Investors, a Massachusetts real estate investment trust, was a co-participant in the loans involved.

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On Petition For A Writ Of Certiorari To The United States Court of Appeals For The Seventh Circuit

RESPONDENTS' BRIEF IN OPPOSITION

The respondents American Fletcher Mortgage Company, Inc. ("Mortgage Company"), American Fletcher National Bank and Trust Company ("AFNB") and American Fletcher Corporation ("AFC") respectfully request that this Court deny the petition for writ of certiorari. The only affiliate of the respondents, other than wholly owned subsidiaries, is American Fletcher Suisse, a Swiss corporation. American Fletcher Mortgage Investors, a Massachusetts real estate investment trust, was a co-participant in the loans involved.

OPINION BELOW

The version of the court of appeals' decision reproduced in petitioner's appendix italicizes various portions of the opinion that are not italicized in the opinion as published in the slip opinion or in the report which appears at 635 F.2d 1247.

QUESTION PRESENTED

Did petitioner's participation in mortgage loans made to a developer for the construction of a condominium project involve a "security" within the meaning of the federal securities laws under the tests set forth by this Court applied to the facts of this case?

STATEMENT OF THE CASE

Background

This case arose from the events following the collapse of a condominium project near Hartford, Connecticut. The project was conceived in 1973 and ground to a halt in the real estate recession of 1974-1975. The petitioner, U.S. Steel Credit Corporation ("Steel"), was one of three participating lenders to the project. The respondent Mortgage Company was the "lead lender" under contracts with each participant. Pursuant to "participation agreements" with the Mortgage Company, Steel made 40% of the loans and was entitled to 40% of all principal repayments and interest paid by the borrower. The other two participants had contracts with the Mortgage Company that differed from Steel's in several respects, but in general the Mortgage Company was to handle the day-to-day administration of the loans for all three. The other two participants were American Fletcher Mortgage Investors, a Boston-based, Massachusetts business trust ("the Trust") which took 50% of the loans, and the respondent AFNB with 10%. The Trust is publicly owned and is controlled by an independent board of trustees. Its daily affairs are handled by the Mortgage Company under a management

agreement. AFNB and the Mortgage Company are sister subsidiaries of the third respondent AFC, a bank holding company.

Proceedings Below

This lawsuit began in May, 1976, after the lenders had elected to take over the project from the developer. The Mortgage Company initially sued Steel for breach of Steel's contractual obligation to fund 40% of the disbursements made to the developer under the loans. The Mortgage Company and AFNB later asserted additional claims against Steel alleging that Steel breached its obligations as a loan participant and interfered with the Mortgage Company's efforts to salvage the project and minimize the losses of all lenders.

Steel counterclaimed against the Mortgage Company for common law fraud and breach of contract in addition to alleged violations of antifraud provisions of the securities laws. The contracts allegedly breached are the participation agreements between Steel and the Mortgage Company. The facts alleged in support of Steel's state law claims are the same facts on which Steel seeks relief under the federal securities laws. Steel's common law claims have not been challenged by pretrial motion.

The record in this case consists of the pleadings, the participation agreements, various other loan documents, affidavits and deposition excerpts. On this record— which presented no disputed facts—both courts below concluded that Steel's participation in the loans for this condominium project did not constitute a "security" within the meaning of the federal securities laws under standards set forth in decisions of this Court. Accordingly, Steel's securities claims were dismissed. All remaining claims of all parties are set for trial on August 17, 1981.

The Transaction

Loan participations in real estate projects of this type are

normally at least $1 million per participant. The participants are large, sophisticated financial institutions such as banks, real estate investment trusts and finance arms of industrial complexes. As the Court of Appeals observed, Steel, like most participants, had the same basic rights as any commercial lender: "Steel retained the rights of a lender to demand foreclosure, preclude substitution or release of collateral, prevent modification of terms of loan obligation, and so on." Appendix 14a. The borrowing was for a designated purpose—the acquisition and development of land and the construction of 150 condominium units. Appendix 13a. The Court of Appeals also noted that the loan was secured by a mortgage on the real estate and was guaranteed by the principals of the development corporation. Appendix 14a. The return to Steel was in the form of interest at a fixed rate floating above the prime rate as prime changed from time to time. It was in no way dependent upon profits of the project. Appendix 13a. Steel's decision to participate in the loans for the condominium project was based upon its own business judgment after its own analysis of the proposed project. Appendix 13a. In short, as the courts below held, Steel's participation in the loans was a commercial real estate loan, not an investment in a "security."

REASONS FOR DENYING THE WRIT

1. The Issues Presented By The Petition Involve Only The Application Of Established Law To The Facts Of This Case

The result here was based upon the standard tests of a "security" within the meaning of the federal securities laws as applied to the facts of this case. The courts below followed the firmly established principles set forth in *United Housing Foundation, Inc. v. Forman*, 421 U.S. 837 (1975), and *Securities Exch. Comm'n. v. W. J. Howey Co.*, 328 U.S. 293 (1946). The *Forman* case holds that literal inclusion within the statutory laundry list of "securities" in

the Securities Exchange Act of 1934 and the Securities Act of 1933 is not determinative. Noting that the statute itself explicitly calls for reference to "the context" of a transaction, this Court in *Forman* held that the focus of a court's determination should be on the "economic reality" of the transaction. Whether or not the federal securities laws apply depends upon four factors:

> "[T]he presence of (1) an investment (2) in a common venture (3) premised on a reasonable expectation of profits (4) to be derived from the entrepreneurial or managerial efforts of others."

421 U.S. at 852 (numbers inserted).

Steel does not ask for any change in the *Howey-Forman* test. No pure law question is presented. Steel conceded that the underlying notes from the developer were not "securities," notwithstanding their inclusion on the statutory list. Correspondingly, the respondents conceded that a participation in a note which itself is not a security *may* under some circumstances be a security if the *Forman* and *Howey* tests are satisfied. Thus, as recognized by the Court of Appeals below,

> "The sole issue is whether Steel's loan participation was a security under the quadruple test developed by the case law."

Appendix 12a. After review of the specific agreements and circumstances involved here, the Court of Appeals found three of the four requirements lacking, and accordingly found no "security." That presents no issue of significance to this Court.

2. The Courts Below Correctly Applied Precedents Of This Court To The Facts Of This Case

The terms of the "participation agreements" were among the facts in the record on which the courts below focused. Their terms are reproduced in Steel's Appendix at pages

45a-49a. These agreements were authored by Steel for this particular project. They defined the various rights and obligations of Steel as a participant and the Mortgage Company as the lead lender. They provided that Steel acquired a "ratable participating share of 40%" in each of the two loans to the developer. Participation Agreement ¶ 1a. The participations were not transferable. ¶ 8. The Mortgage Company, as lead lender, was the nominal party to the loan agreements, mortgages and notes with the developer. However, the Mortgage Company's role was limited to "the processing, closing and administration of the loan obligation" for which it received a small fee. ¶ 1a. The loans were to be disbursed from time to time by the Mortgage Company after first receiving the necessary funds from the participants. ¶ 3. Likewise, payments by the developer of interest and principal were to be remitted promptly to Steel upon receipt by the Mortgage Company. ¶ 5. There was no discretion in the Mortgage Company to fail to remit or to allocate proceeds among the participants.

The participation agreements reserved to Steel virtually all significant rights of a lender.[1] Steel determined to participate in these loans to the developer on specific terms for a specific project. The Mortgage Company had no authority to select other loans and could not modify any of the terms of the loans without Steel's consent. ¶ 2. Nor could the Mortgage Company release or substitute any of the security for the loans without Steel's consent. ¶ 2. The Mortgage Company had no discretion as to the application

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[1] In this respect the arrangement appears to be materially different from the lending devices—also styled "participations"—common in international shipping finance. In that arena, where the participants are numerous and scattered all over the world, administrative ease apparently requires delegation to the lead lender of major discretion, leaving the "participants" much more like the passive investors one associates with a security. *See* Note, *The Colocotronis Dispute: When Is A Loan Participation Share A Security*, 13 J. Int'l. Law & Econ. 165, 180 (1978).

of the loan proceeds as between itself and the participants, nor as among participants. In the event of a material default, Steel reserved the right to require collection of the loans. ¶ 6. Consistent with the ongoing role Steel thus withheld for itself, the agreements expressly limited the Mortgage Company's liability to "wilful misconduct, bad faith or gross negligence." ¶ 5.

The interest on the loans was fixed by the notes as a percentage over floating prime rates. It did not, however, vary as a result of anything the Mortgage Company, the developer or Steel did or did not do. There was no participation by Steel or the Mortgage Company in any profits of the project. The loans were collateralized by the real estate and the improvements to be constructed on it. The value of the things to be acquired or done with the $5,820,000 loaned to the developer—the land, site development (roads, utilities, etc.), amenities (clubhouse, swimming pool, tennis courts, etc.) and the first 150 condominium units—was appraised at over $8,000,000. The loans were also backed by the personal guarantees of the principals of the development corporation.

Moreover, there was no public offering of the participation; indeed, Steel and the other two participants were the only lenders asked to participate. Before making the loan, Steel performed its own analysis on its own "loan proposal" form. It also conducted a thorough investigation of the proposed project including the review of a professional independent appraisal, a market and feasibility study and elaborate data with respect to the development corporation, its principals, the guarantors of the loan and the general contractor. Representatives of Steel traveled to Connecticut and inspected the site and surrounding area. During the course of construction on the project, Steel made additional site inspections and "loan progress reports."

Based upon its analysis of the foregoing undisputed facts in view of the *Howey-Forman* test, the Court of Appeals correctly concluded that Steel's participation was not an "investment" within the meaning of the test but rather a conventional commercial real estate loan based on normal lending considerations (credit, collateral, purpose of borrowing, etc.). Appendix 12a, 13a. The courts below also correctly held that Steel's independent investigations and monitoring of the project and the extent of its contractual control over the management of the loan negated any suggestion that Steel was dependent upon any entrepreneurial or managerial efforts by the Mortgage Company. Appendix 14a. Finally, there was no expectation of "profits" within the meaning of the tests. Steel's only return was in the form of interest at a fixed rate which would not vary with the profitability of the project. Appendix 13a.

The Court of Appeals performed precisely the sort of analysis *Forman* dictates. Steel's suggestion that the Seventh Circuit's decision in this case is contrary to this Court's decision in *Tcherepnin v. Knight*, 389 U.S. 332 (1967), is without basis. Steel cites *Tcherepnin* as support for its proposition that the interest on these loans constitutes profit. Steel Petition 17, 18. The *Tcherepnin* investors, however, received "dividends" on their withdrawable savings and loan shares, not interest as Steel claims. *Tcherepnin* expressly noted that the "dividends" involved in that case were dependent upon the profits of the savings and loan association as a whole. 389 U.S. at 337-39. In contrast, Steel's interest was due, like any other lender's, without regard to the success of the project.

3. The Seventh Circuit's Decision Is Consistent With Prevailing Authority—There Is No Conflict Among The Circuits

Steel urges a return to the now discredited doctrine that anything literally in the statutory list (for example, every

"note" incident to every commercial loan) is a security. But in 1975 this Court in *Forman* expressly denounced the Second Circuit's literal approach in favor of consideration of the "context" and the "economic realities" of the transaction and observed:

> "With the exception of the Second Circuit, every court of appeals recently to consider the issue has rejected the literal approach urged by respondents."

421 U.S. at 849, n. 14.

Since this Court's *Forman* decision in 1975, the only other court of appeals which has considered whether a participation in a loan is a "security" under similar facts is the Fifth Circuit. In *United American Bank of Nashville v. Gunter*, 620 F.2d 1108 (5th Cir. 1980), that court reached precisely the same result as the Seventh Circuit did here. In doing so, the Fifth Circuit expressly overturned its own earlier decision in *Lehigh Valley Trust Co. v. Central Nat'l. Bank*, 409 F.2d 989 (5th Cir. 1969). *Lehigh Valley* was the only Court of Appeals decision that had held that a participation in a loan was a security. However, *Gunter* noted that *Lehigh Valley* was decided using a "literal approach" to the definition of "security" which had since been rejected by this Court in *Forman* in favor of an analysis turning on the "economic realities" underlying the transaction. *United American Bank of Nashville v. Gunter, supra*, 620 F.2d at 1115. Thus, the only appellate court decision differing with the result reached by the Seventh Circuit in this case has been repudiated by the same circuit that decided it. There is no conflict among the circuits.

Since *Forman*, three district court decisions (in the First, Third and Sixth Circuits) have also reached the same result as the Seventh Circuit under analogous facts. *The Manchester Bank v. Connecticut Bank & Trust Co.*, 497 F. Supp. 1304 (D. N.H. 1980); *Provident Nat'l. Bank v. Frankford Trust Co.*, 468 F. Supp. 448 (E.D. Pa. 1979); *FBS*

Financial, Inc. v. CleveTrust Realty Investors, [1978] Fed.Sec.L.Rep. (CCH) ¶ 96,341 (N.D. Ohio 1977). *See also Home Sav. & L. Assn v. Samuel T. Issac & Assoc.*, [Current] Fed.Sec.L.Rep. (CCH) ¶ 97,811 (N.D. Ill. Sept. 8, 1980), in the Seventh Circuit predating the decision of the Court of Appeals in this case.

Two post-*Forman* district court decisions from the Southern District of New York have found the participation interests involved in the cases before them to be securities. *Commercial Discount Corp. v. Lincoln First Commercial Corp.*, 445 F. Supp. 1263 (S.D.N.Y. 1978), and *NBI Mortgage Investment Corp. v. Chemical Bank*, [1976-1977] Fed.Sec.L.Rep. (CCH) ¶ 95,632 (S.D.N.Y. 1976), and [1977-1978] Fed.Sec.L.Rep. (CCH) ¶ 96,066 (S.D.N.Y. 1977). But both decisions deal with different facts and significantly different participation agreements. For example, the *NBI* and *Commercial Discount* participants had no right to demand foreclosure, as Steel did here. Given the myriad relationships that the banking community reaches in various transactions, it is hardly surprising that different transactions may produce different results. But there is no basic difference in the legal doctrines involved in any of these cases.

Steel appears to be urging this Court to reconsider *Forman* which rejected the Second Circuit's now discredited "literal" approach. In its petition, Steel says that the "[Second Circuit's] liberal approach to the 'securities' acts definitions . . . stands in marked contrast to the restrictive interpretation of the Seventh and some other circuits." Steel Petition 12. But the Second Circuit has not dealt with any loan participation case since *Forman*, much less with one identical to Steel's. If and when the Second Circuit finds a security in a loan participation, notwithstanding the views of the Fifth and Seventh Circuits, then and only then will this Court need to consider whether there is a conflict worth reviewing. None presently exists and there is no reason to suppose the Second Circuit will not follow and apply *Forman* if the issue does arise.

4. The Presumption Contention Was Not Raised Below And Is Inappropriate For Review

Steel also now seeks to contend that the Second Circuit's decision in *Exchange Nat'l. Bank v. Touche Ross & Co.*, 544 F.2d 1126 (2d Cir. 1976), which is not a loan participation case, holds that anything literally falling within the statutory definition of "security" is presumed to be a security unless the opposing party sustains the burden of showing that "the context otherwise requires." Steel Petition 13. Steel implies the decision below is inconsistent with this view. Steel, however, did not raise this presumption issue in the courts below and neither court addressed it. Moreover, respondents submit that the record amply supports the conclusions reached by both courts below regardless of any such presumption.

5. This Case Presents No Unresolved Important Question Of Federal Law

No party to this action has argued that a participation in a note is either always or never a security within the meaning of federal securities laws. Indeed, respondents conceded—and the Seventh Circuit assumed—that a participation in a note may be a security under some circumstances. All that is at issue here is the application of familiar tests to the facts of this particular case. Respondents submit that both courts below fully considered the "economic realities" of the situation in arriving at their result. These included the nature, purpose and collateral of the loan, who the participants were, what they did and the relationship between Steel and the Mortgage Company as reflected in the participation agreements.

Finally, state law adequately covers the subject of a participant's rights vis-a-vis a lead lender in a case such as this. Like virtually all loan participants, Steel is a large and sophisticated institutional lender in the business of making multimillion dollar loans to real estate developers. The participants and lead lenders in transactions of this type are fully capable of fending for themselves. They can negotiate whatever duties and standards of liability they wish. In this case the parties defined their relationship with a contract that specified ongoing rights and responsibilities and established a standard of liability for "gross negligence or willful misconduct." Steel's claims against the Mortgage Company for common law fraud and breach of the participation agreements are to be tried in a few months. Steel has perfectly adequate remedies under the state law claims it has asserted. This Court has recently and repeatedly declined to interpret the federal securities laws to expand into areas adequately served by state law. *See, e.g., Santa Fe Industries, Inc. v. Green*, 430 U.S. 462, 478-79 (1977), and *Piper v. Chris-Craft Industries, Inc.*, 430 U.S. 1 (1977).

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted,

Theodore R. Boehm
(Counsel of Record)
James H. Ham, III

Baker & Daniels
810 Fletcher Trust Building
Indianapolis, Indiana 46204
(317) 636-4535

Attorneys for the Respondents